HELP ?

Special article: Japan's economic plight: Fallen idol

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Abstract:
Japan was once feared for its economic might. Today it is feared for its economic weakness - and the harm its ailing system might do to the rest of Asia and the world. Soon, and for the first time, Japan will have a higher jobless rate than America - a telling moment in the shifting origins of the two economies. While America continues to enjoy rapid growth, Japan is in recession. The country's GDP fell by an annualized 5.3% in the three months to March - much more than expected and the second consecutive quarterly fall. Its banks are creaking under their burden of bad loans; this week the yen hit an 8-year low of Y147 against the dollar, before joint intervention by America and Japan pulled it back; the unemployment rate, with further to rise, already stands at a postwar high of 4.1%.

Full Text:

[Headnote]
Japan was once feared for its economic might. Today it is feared for its economic weakness-and the harm its ailing system might do to the rest of Asia and the world. Just how sick is Japan?

SOON, and for the first time, Japan will have a higher jobless rate than America-a telling moment in the shifting fortunes of the two economies. While America continues to enjoy rapid growth, Japan is in recession. The country's GDP fell by an annualised 5.3% in the three months to March-much more than expected and the second consecutive quarterly fall. Its banks are creaking under their burden of bad loans; this week the yen hit an eight-year low of 147 against the dollar, before joint intervention by America and Japan pulled it back; the unemployment rate, with further to rise, already stands at a post-war high of 4.1%.

Things will probably get worse before they get better. Consumer and business confidence is severely depressed. Worries about jobs and the fragility of financial institutions is likely to cause families to save more and spend less in coming months, adding to fears of a self-reinforcing deflationary spiral. Firms, struggling under a mountain of debt and excess capacity, are slashing investment, and exports to the rest of Asia are falling. Over the next year or so more firms will go bust, unemployment will climb, and the scale of the banks' problems may well turn out to be even worse than has been admitted so far. If the recession in the rest of Asia deepens or if America's economy-tripped by a sharp fall on Wall Street, say-falls suddenly into recession, then Japan's economic prospects will look grimmer still.

What a transformation. Ten years ago, anybody predicting that America would grow faster than Japan and have lower unemployment would have been called a fool. Then, Japan's economic superiority was seen not as a momentary or cyclical thing but as something inseparable from its "model". In particular, the blueprint for Japan Inc was based on close links between firms, banks and government officials. These arrangements sheltered managers from impatient shareholders and foreign competition, allowing them to take a long view. Anglo-Saxon capitalism, obsessed with the short term, didn't stand a chance.

Now, many trace Japan's failure back to that same financial root. Under ministry guidance, banks kept weak firms in business, they say, in the end undermining the entire economy. Echoing the earlier logic, the country's current condition is again seen not as a temporary thing but as something that is so deeply embedded as to be almost inevitable. Unless Japan abandons its distinctive model, it will stagnate (or worse) indefinitely.

Economists love to extrapolate. America's current phase of strong non-inflationary growth is expected to continue indefinitely-just as its previous underperformance, relative to Japan, was regarded as permanent. In the same way, many commentators see no way out of Japan's difficulties. Bad as these are, however, they are not as bad as they are often made out to be. The mood of much of today's commentary, which sees a grim future for Japan however far into the future you look, is too bleak.

Japan's recession is likely to grow worse in the short term-but maybe not much worse. Beyond the short term,Japan's prospects are brighter than many currently expect. In the midst of financial crisis, the short term can seem like an age, and people determined to panic will find no consolation in looking further ahead. But the openminded may indeed find some consolation there-not to mention a better basis for their economic forecasts.

Demand or supply?

A first question is whether Japan's downturn is due to deep structural defects or merely to inadequate demand. Many claim that Japan's weak growth of 1.3% a year, on average, over the past six years is largely the fault of stifling regulation and weak industrial management, which in turn have bred widespread inefficiency and a dwindling return on capital. Some conclude that Japan's potential output (what the economy could produce if its capacity were fully employed) has been growing at no more than 1% a year of late, compared with 3-4% a year in the 1980s. If this were true, stimulating demand in the economy would be to little purpose. The only way to spur growth would be to embark on wide-ranging deregulation and structural reform-a process that would take years, however determinedly it was followed. In this case, the medium-term outlook would indeed be bleak.

Undeniably, Japan's structural defects (especially excessive borrowing by firms to invest in projects with low returns) have worsened its problems. But most of the blame for the country's stagnation lies with the government's failure to boost demand. The authorities made a series of errors in monetary and fiscal policy. They were too reluctant to raise public borrowing and cut interest rates in the early 199os, after Japan's financial bubble burst, and then much too quick to tighten fiscal policy again last year.

Viewed from the supply-side, the answer is the same. In any economy, growth in potential output depends on the growth in the labour force and rising productivity. Japan's labour-force growth has slowed from just over 1% a year in the 1980s to around 0.5% in the 1990s, and the workforce is expected to decline in the next century. On the other hand, economic rigidities have not worsened over the past decade (if anything, they may have eased, thanks to some deregulation), so there is no reason to suppose that underlying growth in productivity has fallen sharply. Indeed, productivity growth in manufacturing has averaged 3% during the past five years, exactly the same as in the 1980s.

[Graph]
Caption: Fancy that
[Illustration]
Caption:

On this basis, Japan's potential output is probably still growing by around 2% a year. Since actual growth has been less than this over the past six years, the economy now has a sizeable "output gap"-meaning that it could grow faster for several years without encountering bottlenecks. This is another way of saying that the problem is (lack of) demand, not supply.

Fiscal follies

At this point one faction of the pessimists makes a different argument: supposing that demand is indeed part of the problem, they say, the government is powerless, for one reason or another, to use fiscal and monetary policy to address it. The government did in fact announce a fiscal stimulus of about 2% of GDP in April; and interest rates are currently set at a historic low of 0.5%. But it makes no difference, according to this view: neither easy money nor public spending can prevent Japan being sucked into a deflationary spiral.

As it happens, Japan is not yet in fact suffering from a full-scale deflation. True, producer prices fell 1.7% in the year to May and the prices of equities and land are falling. But a one-off drop in prices due to cheaper imports from Asia, lower oil prices or deregulation in telecommunications is not the same as "deflation". Producer prices are falling in lots of other rich economies, thanks to lower commodity prices. Japanese consumer prices in the aggregate are not yet declining, nor are wages.

There is a danger that Japan may indeed drift towards deflation-but macroeconomic policy ("demand management") can prevent this. It is true that interest rates cannot go much lower, but monetary policy can stimulate the economy in other ways. One is through the exchange rate. The 20% drop in the yen against the dollar over the past year will help not only to boost exports but, more important, to raise import prices and prevent deflation. It will also make Japanese assets look cheaper by international standards and therefore more attractive to foreign buyers.

The argument that fiscal policy is impotent is also flawed. Umpteen packages over the past five years have, it is claimed, failed to boost the economy. But if the impact appeared modest, so was the stimulus. Ministers overstated the scale of their packages by including measures without a direct impact on growth (such as lending by government agencies and the front-loading of previously planned public works). The actual amount injected into the economy over the past five years-through increased public works or tax cuts-was only one-third of all the measures announced by the government*. Much of the deterioration in Japan's budget-from a general-government surplus of 1.5% of GDP in 1992 to a deficit of 3% last year-reflected the automatic fall in tax revenues due to the downturn.

Also, to measure the effects of any stimulus you need to look not just at actual growth rates, but at what growth would otherwise have been. Given the plunge in equity and property prices, the 85% rise in the yen between 199o and 1995 and the troubles in East Asia, Japan's output would have been expected to fall sharply. A large stimulus in 1995-96 did deliver GDP growth of 3.9% in 1996 (see chart 2). But then the government was too eager to contain borrowing: it tightened policy prematurely in 1997 and the economy slowed.

Might fiscal policy be failing now for new reasons? One common argument is that public-sector debt (at almost 00% of GDP) has climbed too high, especially if you take account of increasing future pension liabilities as the population ages. This implies that taxes will have to rise sharply in future-and, in turn, that far-sighted households will therefore save any tax cut rather than spend it. However, long-term government bond yields of only 1.2% hardly suggest that investors are worried about the scale of government borrowing.

In any case, Japan's future pensions bill needs to be put in context. According to the OECD, the ratio of retired people to the labour force will not rise as much in Japan as in Germany or France (see chart 3) Japan also has more room to raise taxes: its tax burden is only 32% of GDP, compared with 45-50% in continental Europe.

Debtors' prison

A more plausible reason to think that Japan's recession might get much worse is the sorry state of its banking system. This will not neutralise the effects of a fiscal stimulus entirely (as the experience of 1995-96 showed), but it may be enough to dampen them. The banks' overhang of bad loansestimated at 80 trillion, or 12% of GDPserves as a brake on new lending, and thus on demand. Also, the bad debts raise anxieties about the security of the banking system, further undermining consumer confidence. The debts need to be acknowledged in all their awfulness, and written off

The government has persistently shied away from that-although it is wrong to accuse it of doing nothing at all. In a policy Uturn in February it announced a Y30 trillion plan to strengthen deposit insurance and to help banks write off bad loans. As yet, little of this has been used, and rumours about banks or life insurers in trouble continue to rattle the markets. Doubts remain over how the money will be usedfoolishly, to bail out insolvent banks, or wisely, to support sound ones? But at least money is now available both to prevent a severe interruption of credit and, should the need arise, to reduce the risk of systemwide failure if more banks go under.

On balance, if-and it is a big if-the immediate storm in global markets can be weathered, Japan's current recession is likely to prove short-lived. The government's latest fiscal stimulus, its biggest yet, combined with the weaker yen, will boost growth strongly in the second half of this year. Calculations by Dresdner Kleinwort Benson suggest that a to% fall in the yen will boost GDP by 1.7% by 1999-roughly the same amount as the fiscal package itself.

Unfortunately, this has to fill a deepening hole left by the slump in exports to the rest of Asia. Two-fifths of japan's exports go to the region, equivalent to 4.2% of its GDP, compared with only 2.4% of GDP bound for America and Germany. It seems likely that the slump in East Asia will knock up to 2% off Japan's GDP this year. Taking all this into account, the Japanese economy is likely at best to see output broadly unchanged, year on year, in 1998.

If demand merely stabilises in emerging East Asia next year, then Japan's exports will not fall much further. Some of Japan's current fiscal stimulus will also make itself felt in 1999, so the economy could enjoy a reasonable recovery. But further fiscal measures will still be required. It is essential to avoid repeating last year's mistake of tightening policy too soon.

[Graph]
Caption: Japan's stop-go-stop policy The future is grey

Policy will need to be kept loose, ideally combining tax cuts with tax reform. A review of taxes is promised after the Upper House elections in July. Cuts in marginal income-tax rates combined with a broadening of the tax base would both boost spending and make the economy more efficient. Japan's top rate of income tax, 65%, is currently the highest among the rich economies. This is likely to be cut to 50%.

The reform agenda

Given sufficient resolve, the government has the means to close the output gap. But it should take steps, in addition, to speed the growth of the economy's productive capacity: demand-side measures and supplyside measures do not exclude each other. Again, the government has made more of a start in regulatory reform, for instance, than it is given credit for. Much more remains to be done, but telecommunications, retailing, transport and energy have all seen deregulation of various kinds. And in April Japan's "Big Bang" began to set its financial sector free.

Relaxing the laws controlling large stores has already increased competition by encouraging rapid growth in the number of big supermarkets and foreign retailers. Deregulation in the oil industry-allowing more oil imports and self-service stations-has sharply reduced petrol prices. The cost of telephone calls has fallen thanks to liberalisation. Since the mobile-phone market was set free in 1994, rates have plummeted and the number of phones has jumped from 2m in 1994 to nearly 40m.

In other ways too, the platform for faster productivity growth is already in place. Japan's labour market is not as rigid as Germany's, say. Wages are more flexible-thanks to the larger part played by bonuses-and trade unions are weaker. In some industries, lifetime employment can make it hard for firms to cut costs-but only about one-fifth of all workers in their 40s is actually in lifetime employment.

Indeed, by international standards, Japan does not measure up that badly. Its rate of return on capital may be a lot less than America's-a fact that has attracted attention lately-but it is no worse than in many European economies. The World Economic Forum's latest ranking of competitiveness puts Japan in 12th place, well above France and Germany (22nd and 24th, respectively). To be sure, continental Europe is hardly a model to aspire to-but then again nobody is condemning continental Europe to perpetual stagnation. Indeed, France and Germany are now enjoying relatively brisk growth.

The biggest supply-side obstacle to future growth may no longer be (if it ever was) excessive regulation or inflexible labour markets, but a corporate culture that finds it easy to tolerate low returns and difficult to tolerate outright failure. If the economy's return on capital is to improve, it will be necessary to close ailing companies more promptly. This is the aspect of the Japanese model which now matters most-and may be the most difficult to change. But recession, financial liberalisation and the squeeze on banks are all playing their part.

Traditionally, managers have faced little pressure to improve their return on assets. Most of their capital came from banks which also held equity in the firm. Troubled firms could stay in business by borrowing more. But as bad loans erode their capital, banks are starting to say "no" to companies, or to charge higher risk premiums. Firms are being forced to turn to the bond market and-thanks to this years financial deregulation-compete with foreign firms to attract capital.

As markets tumble and commentators tear their hair, it is difficult to accept that Japan's recession may have useful side-effects of this kind-but that makes it no less true. Kevin Hebner, an analyst at sBC Warburg, points to several promising signs. For instance, companies are starting to offer stock-option schemes to managers, giving them an incentive to pursue shareholders' interests. More firms are setting explicit targets for return on equity. And some companies have announced plans to buy back shares, as a way to improve that return.

In the new climate, the threat of takeover may also start to play its part in spurring efficiency. Firms have traditionally been protected by their relationship with their bank and by cross-shareholdings held by friendly companies. But as friendly firms themselves face financial pressure, some are demanding a better return, or, desperate for cash, are selling some of their shareholdings to financial institutions. Recent cross-border M&A activity such as the deal between Travelers and Nikko and current talks between Daimler Benz and Nissan Diesel is just the start. Opaque company accounts remain an obstacle to a vigorous market for corporate control-but next year the country is moving to international accounting standards which will improve disclosure.

If all this works, mind you, it will hurt. These new pressures will encourage firms to cut costs, shed labour and use assets more efficiently. In the short term that means plant closures, rising unemployment, and hence more gloomy headlines about Japan's economic prospects. But creative destruction will help Japan to raise its return on capital. Redundancies and bankruptcies are evidence that the economic adjustment mechanism is working at last. Capitalism, you might say, is finally coming to Japan. Pity it had to be the hard way.

[Illustration]

Caption:

[Footnote]

* For details see "How Much is Enough for Japan?", by Adam Posen, to be published by the Institute for International Economics in July.